FEDERAL TAXATION OF INCOME AND PROFITS—DISCUSSION

Professor Robert Murray Haig, of Columbia University, dissented from the definition of income suggested in the paper presented by Professor Fairchild, on the ground that it was so narrowly conceived as to involve numerous serious economic anomalies. He favored a broad definition of income roughly equivalent to the accountant's definition of net profits. A full statement of his views may be found in the *Columbia University Lectures—The Federal Income Tax* (Columbia University Press, 1921) pp. 1-28.

H. M. STEIN.—In regard to the general principles which have been discussed by the previous speakers, I find myself substantially in agreement with Professors Haig and Friday. In my judgment, the income tax should be burdened not merely upon those who receive income in a technical, economic sense, but in accordance with the broader principle of ability to pay. Whether or not, from an economic standpoint, profit upon the conversion or sale of capital assets is income, the income tax should attach if the Congress has the power to make the levy.

Of course, if the recent decision of the Connecticut Court is substantiated by the Supreme Court, the Congress (in the absence of a constitutional amendment) will be without power to tax capital gains, except in the case of traders in capital assets. It seems unlikely, though, that the highest court will adopt such a view, because its last important income tax decision (Maccomber case) may be said to indicate its views. The court defined income as the fruit of capital and labor, including profit upon the sale of capital assets. Again, in referring to the non-taxability of stock dividends, it said that upon the sale of stock received as a dividend a profit might be realized, which would be taxable. Of course, these statements were dicta, but it is quite reasonable to suppose that the same view will be adopted when the definite issue comes before the court.

In one respect I am in accord with the views expressed by Professor Fairchild. Under the recent rulings of the Treasury Department, mere incorporation by a sole trader or by a partnership, without sale or change of beneficial interest, is held to produce taxable income. This is, perhaps, a rigid view, even under the present law, but if it is a necessary ruling the law should certainly be changed. Where individuals receive for their assets merely other evidences (*i.e.*, stock, of substantially the same interest in the same assets, the law ought not to regard the transaction as closed, or as resulting in profit or loss.

There is another provision relating to the profit upon sale of capital assets which, in my opinion, should be amended. At the present time, if assets are sold or exchanged, the entire profit is taxable as income of the year in which the sale takes place, at the very high present tax rates, notwithstanding that the increase in value (profit) may have accumulated over a period of years. The effect of this provision is to hamper normal business transactions, since in many prospective sales the question of resultant taxation is given almost controlling consideration. The law should be amended so as to permit the profit to be spread over the period of years during which the property was held, and the profit for each year taxed at the rates which governed in that year. This was done, under the 1917 law, in respect to

dividends paid out of the earnings of then prior years. It may be that the procedure would be cumbersome, but it would be much fairer to taxpayers, and would react beneficially upon business transactions, and, indirectly, upon the revenue. It might be, perhaps, that in order to save administrative problems a flat rate could be imposed on such profits, depending upon the number of years the property had been held. In other words, the Congress might arrive at a rough equation of the percentage of tax, in respect to property sold at a profit in 1921, or subsequent years, attach one equated surtax rate if it had been held since 1913 and another rate if held since 1914, etc.

Another important suggestion might be stressed at this time, when amendments to the revenue law are being considered generally. That is, the great need for a "net loss" provision. Congress allowed the losses of 1919, if any, to be applied against the profits of 1918, so as to reduce the tax for 1918; also such losses could be carried forward, if the 1918 profits did not absorb them. Such a provision might well be made permanent, but it should, in any event, be adopted for 1920. It was enacted for 1919 on the theory that 1918 profits would be unreal if in the expected price decline of 1919 losses were incurred. As we all know, the decline did not come in 1919, but did arrive in 1920. As a matter of justice to business, and in order to avoid having the government, in many cases, collect in income tax more than the income of the two years together, the net loss provision should be retroactively enacted for 1920. In this connection, it is somewhat surprising that corporations and business men, in general, favor the abolition of the excess profits tax, and in substitution therefor either higher corporation income taxes or an undistributed profits tax. It would seem that the business situation does not justify solidarity of this kind. Corporations which are unprofitable, or only moderately profitable, might well be in favor of the excess profits tax, which would burden more profitable enterprises, rather than consent to a higher tax upon their own very moderate profits, or to a sales or turn-over tax, which they might not be able to pass on to the consumer.

Professor Fairchild's suggestion as to the injustice of denying to stockholders with small incomes the full benefit of the normal tax paid by corporations upon net income distributed as dividends, raises an interesting problem. First of all, the burden is not upon the individual, but upon the corporation, since it is the latter which pays a normal tax upon income that would not be taxable or would be taxed at a lower rate, if only the ultimate recipient were obliged to account for it. If a change were made, such as Professor Fairchild advocates, the result would be to affect seriously the relations of preferred and common stockholders. Up to the present time, the corporation has paid the normal tax, and dividends have been exempt therefrom. In connection with the preferred stock issues of the last few years, the corporations have impressed that fact upon investors, and have presumably received a price for their stock which reflects the value of the exemption. If preferred dividends were now made subject to normal tax in the hands of the holder, it would be a benefit to the corporation, *i.e.*, to the common stockholder as residuary owner, and preferred stocks would presumably decline in value, perhaps 5 to 10 per cent. There does not seem to be any justification for having the government shift the burden away from those who have agreed to assume it. There is no question here of the gov-

ernment raising revenue. It is merely a question of whether the government shall continue a policy under which A pays what he has agreed to pay, or shall change it so that B is obliged to take up A's burden. In this connection it should be stated that when withholding against residents was discontinued, the provision for withholding 2 per cent, in the case of tax-free covenant bonds, was inserted in the law, in order to protect the contractual rights of bondholders. Up to 1916, the maximum normal rate had been 2 per cent, and Congress no doubt considered that practically all contracts made were upon the understanding of a normal tax rate not exceeding 2 per cent. Therefore, when the normal tax was raised and general withholding abolished, withholding at 2 per cent on tax-free covenant bonds constituted substantially adequate protection to the bondholders. If a change were now made in respect to the normal tax on dividends, it would seem that similar considerations should govern.

George O. May.—I am very glad of an opportunity of speaking here, though I speak not as an economist but as an accountant. I have been greatly interested in Professor Fairchild's paper, but I find myself perhaps more closely in agreement with the views of Professor Haig than with those of Professor Fairchild.

In distinguishing between capital and income I think it is very desirable to deal separately with two elements that may contribute to an increase or decrease of capital as expressed in terms of money. One element is the increase or decrease inherent in the nature of the capital asset (to use the accountant's term); the other is the fluctuation in value of the capital asset due to changing price levels. Speaking as an accountant I would say that any increase or decrease of capital due to inherent causes must be taken into account in determining income. Theoretically I should not regard any increase or decrease in the money value of capital assets, due to a general rise or fall in price level, as being in the nature of income. It may be, however, that as a practical problem the difficulties of separating the two may make it expedient to treat them on the same basis, and in that case I should prefer to meet the situation by extending the definition of income to cover both elements, rather than to narrow it so as to exclude both. It seems to me that accepting the definition of income as the services of capital, the creation of additional capital must properly be regarded as such a service, and, conversely, the exhaustion of capital as a corresponding disservice. While dealing with this point I should like to draw attention to the confusion of thought which frequently arises in business and accounting circles, and possibly in economic circles, from the use of the words "depreciation" and "appreciation" without regard to their elements. The increase in the value of a reversion as its maturity approaches, or the decrease in the value of an annuity as its term becomes exhausted, is entirely different in its nature from the increases and the decreases in the value of reversions and annuities resulting from changes in interest rates. Much unsound accounting and unsound finance has been based on a failure to recognize the difference, the commonest case being where unrealized, unrealizable, and perhaps purely temporary appreciation of, say, land has been treated as offsetting the depreciation of physical plant resulting from the actual exhaustion of its useful life.

In regard to Professor Fairchild's proposal to tax earnings of corpora-

tions to the individual stockholders, as and when dividends are declared, and not to the corporations, I think in theory there is much to be said for it. In speaking of the undivided profits tax, Professor Fairchild refers to it as being necessary as a practical proposition, and I think it is as a practical proposition that the proposal to refrain from taxing corporation profits as such falls to the ground. I might in passing refer to the injustice which Professor Fairchild mentions as arising from the taxation at 10 per cent of corporation profits which accrue ultimately to stockholders who should properly be taxed at only 4 per cent. This injustice, if it be one, could be remedied very simply, as all that would be necessary would be for the stockholder to return his dividends as income and deduct from his tax an amount equal to the corporation income tax on the amount of dividends included in his gross income. I was in the Treasury when the present tax law was passed and I think some at least of those who supported the bill regarded the discrimination of which Professor Fairchild complains as a step, a halting step perhaps, in the direction of preferential treatment for earned income as against invested income.

I was interested to see what definite proposals Professor Fairchild would make in respect to the undistributed profits tax, and particularly how he would meet, first, the problem of assessing his tax so as not to discourage legitimate retention of profits in business, but to penalize retentions for the purpose of avoiding surtaxes on shareholders; and, secondly, the difficulty of avoiding the same injustice to small stockholders of which he complains as resulting from taxation at 10 per cent of corporation profits which accrue to a shareholder properly tax free or taxable only at 4 per cent. I found, however, that his proposals did not meet either difficulty: to do so it seems to me that the form of the tax would have to take into account the character of the business and the taxable status of the stockholders. There are a great many companies which have a large part of their investment in the form of wasting assets, such as mines or timberlands, which are in a position to distribute all their earnings in dividends. On the other hand, a new company building up a new business may require to retain all its profits in the business in order even to survive. In these circumstances, to adopt either the amount already invested or a percentage of the total net income or surplus as the basis for exemption or graduation fails altogether to do justice.

The second point is perhaps of even greater importance. In many of the great public companies, with such a tax in existence, there would be on the one side a large body of small stockholders with relatively small incomes whose interest would lie in the distribution of profits and the avoidance of the undistributed tax even if it were necessary to reinvest the amounts distributed as additional capital. On the other side would be the stockholders subject to heavy surtaxes, whose interests would be best served by the retention of the profits in the business even at the cost of the undistributed profits tax. There would thus be a direct conflict of interests between the different classes of stockholders. As a general rule the large stockholders would be those principally represented in the board of directors, and the probabilities are that the small stockholders would suffer in many cases for the benefit of the large stockholders.

I might mention one other point in connection with an undistributed profits tax. The methods which determine taxable net income are not nec-

essarily those which determine the income which a company can properly and legally distribute as dividends. You cannot measure taxable undivided profits by comparing taxable net income with dividends paid, without doing grave injustice in many cases, though the acceptance of the "cost or market" rule for valuation of inventories has greatly reduced the number of such cases. Consequently the adoption of the undistributed tax would involve new complexities in returns and administration or, as an alternative, new injustice.

It may be that an undivided profits tax is inevitable and that it would do less injury than the alternatives which might be suggested as substitutes for it, but I think we must realize that it is impossible to apply it without producing serious inequities and other highly undesirable consequences.

JOHN WHYTE.—Independently of Professor Fairchild, the Committee on Federal Taxation of the National Association of Credit Men has come to very similar conclusions. This Committee advocates the elimination of the Excess Profits Tax and the elimination of the Corporation Income Tax. It proposes then that dividends from current earnings of corporations be subject to the normal tax in the hands of the individual. It proposes, further, a tax on the current year's earnings of corporations, not distributed,—this tax to be at a graduated rate. These proposals are identical with those made by Professor Fairchild.

The Committee diverges from Professor Fairchild's recommendations in that it discards entirely the valuation of assets as a method of basing the tax on undistributed corporate earnings. The reason for rejecting this method of basing and applying the tax is to be found in the difficulty of defining and determining invested capital.

The purpose of this tax on undistributed earnings is to achieve equalization. The tax is to be so framed as to have the following result:

The tax on the undistributed earnings of a corporation plus the tax on distributed earnings of a corporation (this last tax to be paid by individual shareholders) should approximate the total tax that would be paid by individual shareholders if the earnings of the corporation were all distributed.

To achieve this approximation a graduated rate must be used. The reason for this graduated rate is, of course, the fact that individual shareholders pay taxes under the progressive income tax and pay, therefore, at a graduated rate. If, for example, a large percentage of the earnings of a corporation are distributed, these earnings will be subject to a relatively higher rate of tax under the progressive income tax than would a smaller distribution of the earnings of the same corporation. As a general rule, the greater the distribution the higher will be the rates to which that distribution (in the hands of the individual shareholders) is subject under the progressive income tax. To compensate for the relatively high rates that apply on a large percentage of distributed earnings, the rate on the *small percentage* of *undistributed earnings* should be low. If, on the contrary, the percentage of distributed earnings is low and thus presumably subject to lower brackets under the individual income tax, the rate on the *large* percentage of *undistributed earnings* should be compensatingly higher. The following formula may express the situation more clearly:

Tax on distributed earnings of corporation plus tax on undistributed earnings equals roughly the tax on total distributed earnings of same corporation.

I quote here from the Report of the Committee:

A Tax on Undistributed Earnings Based of the Percentage Undistributed

The Committee feels, giving weight to both the considerations of equity and simplicity, that the most desirable factor on which to base this undistributed earnings tax would be the percentage of the total current net income which remains undistributed, and considers this factor as being of the greatest importance in seeking equality as between different individuals who prosper equally.

To illustrate, taking the case of an individual who has a $40,000 share in the current income of a corporation. If the corporation were to distribute 25 per cent of its current net income in dividends, this individual would pay an individual income tax on $10,000. If the corporation were to distribute 75 per cent of its net income, this shareholder would pay individual income tax on $30,000, and on the difference of $20,000 received under the last example he would be paying a gradually increasing rate.

The tax on undistributed earnings is recommended for the purpose of equalizing, as far as possible, the tax borne by this man when the corporation distributes but 25 per cent, and pays on his behalf taxes on the 75 per cent remaining. It is obvious, since the individual would pay at a gradually increasing rate, if he pays his own taxes, that when the corporation pays his tax for him (by paying a tax on earnings undistributed to him) the rates should be such as to be in a measure comparable. The rates should aim to produce the proper revenue but not at a sacrifice of substantial equality.

The recommendation therefore is that the application of the undistributed earnings tax be based on the percentage of the total net income which remains undistributed and therefore free from income tax in the hands of the individual.

Rates

This tax on undistributed earnings, being in lieu of taxes which would be paid on similar income by an individual receiving such income from a source other than corporate investment, should in its lowest bracket be equal to the lowest bracket of the individual income tax (4 per cent under the present law). The fixing of its highest bracket should be governed by two considerations: (1) the greatest measure of equity to the shareholders as compared with other individuals; and (2) productivity from a revenue standpoint.

The Secretary of the Treasury, the Honorable David F. Houston, in his annual report dated Nov. 30, 1920, suggests that the rates of surtax on that part of the net income which is saved and reinvested in business be reduced by one-fifth and in no instance exceed 20 per cent.

The recommendation heretofore made provides that the individual shareholder should pay his own normal tax. Should that be enacted into law, it would mean that the maximum rate of this proposed undistributed earnings tax would be 28 per cent; namely, the equalizing 8 per cent normal tax, plus 20 per cent maximum surtax which would be the tax maximum paid by the individual if the earnings were distributed to him and reinvested in securities the income of which is subject to tax. Therefore, we give for purposes of illustration, a tentative basis on which we may erect a schedule of rates. The making of rates, however, being a function of Congress, this Committee does not presume to suggest what the rates should be, but above they have endeavored to set out the best thought on the subject and the following tabulation is submitted for the sole purpose of illustrating the manner in which whatever rates might be determined on would be applied.

With the foregoing in mind, the rates might, for example, be as in the following table. For the sake of simplicity in figures, the example is based on a corporation with a net income of $100,000, making no distribution. The undistributed earnings tax in this case would be as follows:

		Tax Rate	Amount of Tax	Cumulative Total
On the first 10% of the total net income which remains undistributed	$10,000	4%	$400.00	$400.00
On the next 10%	10,000	8%	800.00	1,200.00
On the next 10%	10,000	12%	1,200.00	2,400.00
On the next 10%	10,000	16%	1,600.00	4,000.00
On the next 10%	10,000	20%	2,000.00	6,000.00
On the next 10%	10,000	24%	2,400.00	8,400.00
All over 60%	40,000	28%	11,200.00	19,600.00

The rates might be subjected to either more or less graduation than shown above, as the graduations above were made few and simple for the purpose of clarity. Also, the point at which the maximum rate is made to apply might be shifted either up or down as necessities seemed to warrant.

The Undistributed Earnings Tax Will Not Force Undue Distribution

The only argument which has been brought forward against the tax on undistributed earnings is that it would force distribution to shareholders of earnings which were needed in the business, this distribution being forced to avoid payment of the undistributed earnings tax by the corporation. This argument is fallacious for the following reasons:

Corporations are managed by boards of directors, which control payment of dividends by the corporation. The personnel of boards of directors is almost invariably made up of the principal owners or their representatives.

If the above mentioned argument were sound, we should have to conclude that a board of directors would pay themselves dividends on which they would be obliged to pay a personal income tax in order to avoid bearing their share of a comparable tax assessed against the corporation, and that they would pay themselves these dividends and in so doing undermine the security of their investment in the corporation.

It does not seem to this Committee that any such accusation of intellectual weakness is justified against the owners of the corporations of the country.

It seems to the Committee that those corporations which are well managed and which are earning income, and therefore are the ones to which this tax would apply, are competent to manage their affairs, and will not undermine the security of their investment for the purpose of exempting the corporation from tax and according themselves the privilege of paying a comparable tax on such income.

Such a tax would not in any way restrict expansion commensurate with the legitimate requirements of the business, although it might act as a deterrent to any abnormal expansion which the Committee believes should be financed through new securities, thus obtaining the consent of all the shareholders to the program.

The Secretary of the Treasury in his report just recently issued, has suggested an additional tax of 6 per cent on corporate incomes.

Your committee believes that there is no sound reason why there should be any tax paid by corporations on the income which they distribute. Many eminent legal minds, including the members of the Supreme Court of the United States, have stated that a corporation is merely an aggregation of individuals; and your Committee, believing as it does in the principles of taxation of income on the basis of ability to pay, and believing that every individual of the country should be permitted to pay his own tax, can see no reason why any tax should be paid by the corporation against that part of the income which is distributed to the shareholder and therefore can be equitably taxed in his possession. Any flat tax on corporations deprives the small shareholder not only of the personal exemption the law accords him, but also deprives him of the benefit of the lower rate on the first $4000 over his exemption.

It seems to your Committee that there is no reason why a corporation as such should pay any federal tax which is not in like manner assessed against a partnership or an individual conducting an identical institution.

The present tax law is collecting in the neighborhood of $100,000,000 from the corporations of the country under the capital stock tax for the privilege of doing business in corporate form. If the federal government is to levy any tax on the privilege of doing business in corporate form, then it would seem that such a tax as the capital stock is the fairest measure possible under the Constitution.

The corporation income tax has been generally considered as paid in behalf of the shareholders in lieu of the normal tax, and dividends have accordingly been made exempt from the normal tax. Under this plan, the corporation income tax and the individual normal tax should be at the same rate.

The recent report of the Secretary of the Treasury suggests a still wider spread between the flat individual normal rate and the corporation income tax rate. If this extra rate on corporate income is designed to be a tax on the privilege of doing business in corporate form, it is fundamentally wrong. At first glance it seems to be founded with only one idea in mind: to get the money.

Any tax on the total net income of corporations designed to equalize the taxes paid by partners or sole traders on the undistributed earnings of their business should not be considered for the reasons that we have pointed out elsewhere.

THE ADVANTAGES OF THE UNDISTRIBUTED EARNINGS TAX

In so far as it is practicable the undistributed earnings tax will equalize taxation.

1. It will thus be closed to the serious objection which is directed against the excess profits tax and may be directed against some of the substitutes proposed for it.

2. Since it is an extension of the income tax principle, it does not require the setting up of new tax machinery.

3. It combines with the income tax flexibility of rate.

4. By removing the penalty that rests on small shareholders, it will encourage the investment on the part of larger groups in shares of corporations and thus contribute to the financial and economic stability of the country.

PROFESSOR FAIRCHILD.—The discussion this morning has brought out one conflict of opinion which is fundamental. This has to do with the theoretical definition of income and the distinction between income and capital. It was not my intention in this paper to bring up again any lengthy discussion of this old question. As I have already stated, this is a point upon which there has been difference of opinion among economists, and although the matter was discussed at length at the annual meeting of this Association in 1908, it is not surprising to find that difference still persists. I was not myself present at that meeting, but my reading of the PROCEEDINGS has led me to the impression that the advocates of the definition of income which I have used this morning had decidedly the better of the argument, and I am still of that opinion. For the purpose of the problem before us today we must simply recognize that a difference of opinion exists among economists as to the theoretical definition of income.

Now when we come to the practical problem before us this morning—namely, how to carry over into the field of the income tax our economic concept of income, it should of course be obvious to everyone that no theoretical concept can be applied exactly without numerous inconsistencies and difficulties necessitating as a practical matter many qualifications and adjustments. This result will come no matter what theoretical definition we take as the starting point. That definition will be most useful in the practical problem which in the long run causes the least of such difficulties and necessitates the fewest adjustments. From this standpoint I am decidedly of the opinion that the definition of income which I have used has the advantage over that definition which would include increases in capital value as income.

Professor Haig in particular has pointed out difficulties which would follow the application of my definition. In this he has been generous. He might easily have added to his list. In my study of this matter the difficulties which he mentions and many others have been foreseen. They may generally be overcome without meeting any insuperable obstacle. But suppose we turn to the definition which he proposes. We are then immediately confronted with an overwhelming swarm of difficulties, to a very few of which I should like to call attention.

1. Gifts and inheritances should logically be included in income, with practical results which are not pleasing to contemplate.

2. Capital frequently increases in value merely on account of the depreciation of the currency standard. To consider such increase as income is fundamentally unjust and, in extreme cases, ruinous. Complaints and petitions for relief have come in great volume from the business world on account of the injustice done by counting as income appreciation

in value of assets even in cases of annual inventories, where the matter is far less serious than when it has to do with revaluing permanent capital assets. Professor Haig has suggested that this difficulty is to be met by the application of an index number correction. Others have thrown doubt upon the usefulness of this device. Personally I hope the time may come when we shall have devised some arrangement to correct the fluctuations of our monetary standard, but at best this is in the more or less distant future. What we are considering today is a present practical problem.

3. To bring out clearly the simple principle, take A who owns a forest whose value on account of the growth of the timber is increasing at the rate of $1000 a year. B receives an income of $1000 a year from salary, interest, or dividends. According to Professor Haig's definition of income, these two men are in the same situation and should be taxed alike. The fact is, they are not at all in the same situation. A during the time his forest is growing to merchantable size receives no service from it. It yields no income, yet he is compelled to pay an annual tax, to meet which his capital furnishes him no funds. Suppose after twenty years, before any timber is cut, the forest is destroyed by fire. A has received no income under my definition. He has certainly realized nothing from the forest, and his position is the *reductio ad absurdum* of that definition which includes as income increase in value of capital assets. It is true that he could now be allowed to deduct his loss, but this he can do only to the extent to which he has income from other sources from which to make the deduction. He is granted no return of the tax paid in respect to income never received. This is an extreme case. But other cases of injustice differ from it only in degree, on account of the shorter term for which the investment runs before yielding a return. Treating as income the gain from sales of more or less long time investment has produced innumerable cases of injustice under the present law.

4. A serious objection to regarding increase in capital value as income has been brought out by Professor Haig, namely, the injustice which results from taxing large gains irregularly received, under an income tax with a variable rate. Professor Haig thinks this consideration must lead us to abandon the variable rate, yet the variable rate itself is one of the best features of the income tax. Great Britain has always regarded the income tax as the elastic element in her revenue system, although in recent years her income tax has been strained to the limit of elasticity. It is by means of the variable rate that the income tax is to be used to balance the budget and to bring home to the taxpayers the results of legislative economy or extravagance. This in my opinion is one of the most fundamental advantages of the income tax. It is this which gives some hope that the income tax may be the instrument to lead us out of the wilderness of congressional extravagance. Expenses must be met, and taxation is the only ultimate way to meet them. Our only possible safety lies in bringing home to the minds of the people the fact that they must bear the burdens of legislative expenditures. Herein lies the one good feature of the American general property tax. Every year the selectmen or other local officers must figure up the tax rate. Its public announcement evidences the burden which every taxpayer must bear on account of town expenditures, and the taxpayer is thereby made to realize the advantage of economy. It is fervently to be hoped that the federal income tax, with a rate changing from time to

time, may thus serve a beneficent purpose in checking congressional extravagance. All this we sacrifice if the rate must be fixed with relative permanency.

I have laid myself open to attack through introducing for discussion this morning, by brief reference only, certain topics which there has not been time to discuss in full. For example, Mr. May has criticized the proposed tax on undistributed earnings on the ground that it would bear too heavily upon newly organized corporations which are just getting on their feet and which for some time need to turn back most or all of their earnings into the business. If Mr. May had had before him my article in the December REVIEW he would have found this matter foreseen and provided for by means of the graduated rate based on size of invested capital as well as the special provision for small corporations.

Mr. May has likewise failed to grasp fully the argument in favor of substituting the individual taxation of dividends in place of the corporate income tax. If he had read my article in the December REVIEW I think he would not have made the proposition that to remedy the injustice to which I refer "all that would be necessary would be for the stockholder to return his dividends as income and deduct from his tax an amount equal to the corporation income tax on the amount of dividends included in his gross income." The main point of my criticism of the present system was that all corporate income is taxed at 10 per cent, whereas if the tax were upon the individual, income received from corporate investment would be taxed either 8 per cent, 4 per cent, or not at all, according to the circumstances of the individual taxpayer. Mr. May's device fails to meet this difficulty, since he would still leave all corporate income taxable at 10 per cent.

To illustrate by a single example, suppose A owns $50,000 worth of stock in a corporation of $1,000,000 capital. The corporation's net income is $80,000, of which A's share is $4000. The corporation is taxed 10 per cent on its net income less $2000, or $7800, which reduces A's share by $390, and makes his dividend $3610. Assuming that he is entitled to a personal exemption of $2000, and has no other income, his income tax would be $64.40, leaving a net income of $3545.60. If the deduction which Mr. May suggests is to be granted only to the extent of his tax, he will, it is true, be relieved of the entire tax of $64.40, but it is obvious that this goes only a short way toward remedying the injustice done him. This could be done only if the government actually gave him a rebate of the full $390 which the corporation paid in tax upon his share of its income. This I take it Mr. May does not propose. His proposition does indeed to some extent reduce the injustice of the present method, and to that extent should be welcomed if nothing better can be secured.

Furthermore, Mr. May's suggestion fails entirely to meet another important reason for advocating the individual taxation of dividends. I refer to the psychological effect upon the taxpayer of feeling that governmental expenditure comes back upon him in the form of heavy income taxation. Mr. May's device would still leave the ordinary taxpayer with the comfortable feeling that it made no difference to him how heavily the corporations were taxed.

The question has been raised whether my definition of income, carried to its logical limit, does not mean the exemption of savings and amount virtually to a tax on consumption. In my original remarks I expressly stated

that it was not my intention to press the definition to this limit in its practical application. As a matter of theory, it is quite possible to carry the definition to this logical conclusion, and much is to be said in its favor. Since, however, we are dealing with the practical problem of the revision of the American income tax, and since I admit that there is at present not even a slight possibility of a general exemption of savings, this matter appeared to be of theoretical interest only, and on this ground I expressly refrained from going into it. It is a matter which I hope to examine at some future time.

Mr. Stein has objected to making the income tax a purely personal tax on the ground that dividends from preferred stock would thus become taxable, with a corresponding depreciation in the value of such stock. This I should regard as rather a backhanded argument. As a matter of fact the peculiar position of preferred stock is one of the strongest arguments for doing exactly what I proposed. Under the present tax system, dividends on preferred stock are absolutely untaxed so far as the normal tax is concerned. The tax on corporate net income is supposed to be in lieu of the normal tax on dividends, but it affects only the dividends on common stock. The corporate income tax falls entirely upon the common stock. Whatever its amount, there is no reduction from the dividends to preferred stockholders, until the corporation's earnings are reduced below the amount of the dividends due to preferred stockholders. This is one of the anomalies of the present system. It disappears under the plan I have proposed. That correction of an anomalous situation will involve readjustments is scarcely an argument against making the change.

In applying scientific principles to practical problems, we must all contribute what help we may. The function of the economist, I take it, is to present fundamental principles and see that they are carried out in practice so far as the demands of the particular case permit. The accountant, on the other hand, starts from the other end. His attention is primarily on the practical problem to be solved, and he is inclined to form his definitions and state his principles with a view to the immediate necessities of the particular case. It is the business of the economist to take a long range view and to insist that whatever is done to meet the present problem be not superficial and in violation of sound principles, lest the stage be set for future trouble. Both points of view are essential to the solution of such a problem as that of framing a national tax system.